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SUBJECT: El SALVADOR: ECONOMIC AND TRADE UPDATE

REF: A. SAN SALVADOR 1913 B. SAN SALVADOR 1964

¶1. Summary. According to Central Bank indicators, economic activity has remained buoyant in El Salvador during the first half of 2007. GDP for the first quarter of 2007 increased by 4.01 percent and the Bank's Index of the Volume of Economic Activity increased by 4.01 percent for the first half of the year. Formal employment increased by 7.6 percent between May 2006 and May 2007, and the annual inflation rate remains stable at 3.6 percent as of August 2007. Although the trade deficit increased by 16.5 percent, exports of non-traditional products have also increased. Based on performance in the first half of the year, it seems probable that El Salvador will meet government growth and inflation projections by the end of the year. End Summary.

GDP UP

¶2. According to Central Bank estimates, GDP grew at 4.01 percent during the first quarter of 2007, and the Central Bank's Index of the Volume of Economic Activity (IVAE), a GDP proxy, increased by 4.01 percent during the first half of 2007. All sectors showed growth, especially agriculture and transportation, communications, and storage.

EMPLOYMENT UP

¶4. Formal employment, as measured by the number of private sector workers ascribed to the Social Security Salvadoran Institute (ISSS), increased by 7.6% between May 2006 and May 2007. All sectors showed employment increases, including manufacturing, which had suffered in previous years because of reductions in the maquila industry.

INFLATION STABLE

¶5. The annual inflation rate for August 2007 reached 3.6 percent while the accumulated inflation rate for 2007 reached 2.47 percent, below the 3.77 percent recorded in August 2006. The inflation rate went down primarily because of lower gasoline and corn prices. El Salvador has the lowest inflation rate in the region, and the Bank projects it will meet the government projected inflation rate of between 3 and 4 percent for the year.

TRADE EXPANDS

¶8. According to GOES trade data, during the first semester of 2007, total exports increased by 4.7 percent to $1.94 billion, while total imports grew by 10.6% to $4.103 billion, and El Salvador's trade deficit grew by 16.5 percent to $2.163 billion. Non-traditional

exports were the most dynamic, expanding by 13.3 percent, while Traditional and Maquila exports decreased by 5.3 percent and 1 percent respectively. Within non-traditional exports, goods exported to the Central American region represented 62.8% of the total, up 13.8 percent, while goods exported outside of the region increased by 12.6 percent.

¶9. A large part of the increase in non-traditional exports can be attributed to the United States, Central America, and Dominican Republic Free Trade Agreement (CAFTA-DR) entry into force. For example, by taking advantage of a flexible rule of origin granted by CAFTA-DR, ethyl alcohol quickly became the second largest non-maquila export after coffee. Ethyl alcohol exports to the US reached $64.6 million during the first semester of 2007, representing 6 percent of non-maquila exports. Food & beverage and other non-traditional exports have also increased (reftel A).

¶10. The Maquila sector is showing signs of stabilizing, with exports decreasing slightly (1 percent) during the first semester of 2007, to $860.6 million. Despite the reduction that the sector has been experiencing for the last 3 years, Maquila still remains the most important export category (reftel B).

¶12. During the first six months, total exports to the United States decreased by 0.5 percent, to $1.06 billion, according to GOES statistics. However, U.S. Department of Commerce and Census Bureau figures show Salvadoran exports to the United States have actually increased by nearly 15 percent. The U.S. share of total exports decreased from 57.7 percent to 54.9 percent, primarily attributed to reduced maquila exports. On the other hand, exports to Guatemala and Honduras increased by 15 and 17 percent respectively. The main destinations for Salvadoran exports after the U.S. are Guatemala, Honduras, Nicaragua, and Costa Rica. Total imports from the United States grew by 12.4 percent to $1.7 billion, and the U.S. share of

total imports increased from 41.4 percent to 42 percent. Other important sources of imports after the U.S. are Guatemala, Mexico, and China.

REMITTANCES GROWING, BUT SLOWER

¶13. Family remittances reached $2,344.7 million by the end of August 2007, a 7.7 percent increase over the previous year. This is lower than the 18.5 percent growth rate for the same period of 2006. The Central Bank projects that remittances will reach more than $3.5 billion by the end of 2007, equivalent to 18 percent of GDP.

FDI EXPANDING

¶14. The total Foreign Direct Investment (FDI) stock increased by 8.5 percent from $3.478 billion to $3.774 billion between March 2006 and March 2007. The electricity sector accounted for almost half of this increase ($135.3 million), while communications received more than a quarter of the total ($77.4 million). The United States accounted for 64.9 percent of total FDI ($192.1 million), followed by Spain at 24 percent ($70 million). Italy invested $47.4 million, Panama $38 million, and neighboring Guatemala $18 million.

TAX REVENUES INCREASE

¶15. Tax revenues increased by 12.4 percent to $1,544.6 million during the first six months of 2007 (7.7 percent of yearly GDP). Since 2004, when tax reforms were implemented, tax revenues have increased by 51.4 percent. As a result, the tax burden has increased to 7.7 percent of GDP, 0.3 percentage points over the first semester of 2006. The Ministry of Finance forecasts that the tax burden will reach 14.2 percent of GDP by the end of the year, compared to 13.8 percent of GDP last year. For 2008, the Ministry of Finance expects tax revenues to increase by 9.9 percent. They also plan to reduce public debt from 36.8 percent of GDP by the end of 2007 to 33.8 percent of GDP for 2008, and plan to reduce the fiscal deficit from 2.3 percent to 1.9 percent of GDP.

COMMENT

¶16. El Salvador will likely achieve government growth projections of between 4.5 percent and 5.5 percent, and the inflation rate appears to have been kept under control despite surges in oil prices. Increased exports, due in part to CAFTA-DR, and increased foreign investment are also positive economic trends that suggest continued economic expansion.

¶17. Nevertheless, there are still several factors hindering economic growth and development prospects, especially public security/crime. The latest Economic and Social Development Salvadoran Foundation (FUSADES) survey, covering the second quarter of 2007, shows that even though entrepreneurs perceive a favorable investment climate, 25 percent of entrepreneurs reported being victims of crime during the 3 months previous to the survey. Political uncertainty as the country moves towards elections may also slow growth, especially in foreign investment, as investors may decide to wait who wins the election before expanding or entering the market.

Glazer